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OPEN MARKET OPERATIONS: EXPECTATIONS AND CHALLENGES

Dr. A. J. Haja Mohideen

Associate Professor & Head, PG & Research Department of Economics, Jamal Mohamed College, Trichirappalli

ABSTRACT

The RBI move of sucking out excess liquidity through OMOs clearly shows the tightening attitude to control inflationary pressures. Monetary policy got a hawkish tint as the market did not expect such a suck out policy of excess liquidity from the RBI, though the retail inflation was at 6.83 per cent in August 2023. Larger government borrowings and abundant supply of liquidity are the great concerns to RBI. The RBI's emphasis on active liquidity management was influenced by inflation risks and financial stability. Fiscal Dominance Liquidity Management Challenge and Exchange Rate Volatility are the challenges ahead. OMOs effectiveness depends on the central bank's ability to accurately time and size these operations.

KEYWORDS: Liquidity, Monetary Policy, Speculation, Exchange Rate Volatility, Government Securities

INTRODUCTION

In the month of October 2023, RBI announced its plan to consider the Open Market Operation (OMO) to manage liquidity in the system. The RBI move of sucking out excess liquidity through OMOs clearly shows the tightening attitude to control inflationary pressures. This announcement surprised the bond market as the RBI did not indicate any specific timeline for the OMO.

Basics of OMOs:

OMOs are the sale and purchase of government securities by the RBI in the open market. OMOs are used by RBI to manage rupee liquidity conditions in the market. It is a monetary policy instrument that influences short-term interest rates by regulating the banking system's money supply and liquidity. Controlling the money supply in the economy is the primary goal of OMOs. It aims to manipulate an economy's short-term interest rate and supply of base money. During inflation RBI sells securities and absorbing excess liquidity (Contractionary monetary policy). To expand the market money supply during a recession, RBI buys securities (Expansionary Monetary Policy). OMOs are carried out through commercial banks.

When there is excess liquidity in the market, RBI sells government securities, thereby sucking out the rupee liquidity. Similarly, when the liquidity conditions are tight, it buys securities from the market, thereby releasing liquidity into the market.

OMO purchases by RBI inject more liquidity into the banking system as it pays for securities by releasing money. This will reduce interest rates in the economy. RBI's buying of securities increase the demand for bonds and thereby raising the securities prices and falling of bond yields. On the other hand, OMO sales absorb liquidity from the market. Due to the increased supply of securities by RBI their market prices will fall and thereby raising bond yields. With reduced liquidity, banks demand higher yields on bonds and bond buyers demand more interest rate on these securities. It is to be noted that market interest rates and bond prices are inversely related.

Reasons behind RBI's Move:

Monetary policy got a hawkish tint as the market did not expect such a suck out policy of excess liquidity from the RBI, though the retail inflation was at 6.83 per cent in August 2023, It is to be noted that though the inflation was in the RBI's comfort band of 4 ± 2%, the unexpected proposal caused the yield on the benchmark 10-year government bonds to shoot up by 12 basis points to 7.34 per cent as the market now is waiting for an OMO shortly.

RBI aimed at anchoring inflation at 4 per cent. But having increased inflation for much of the year for the year 2023, RBI had a rethink on inflation control, that is keeping inflation below the upper band of the target range (at 6 per cent) is insufficient. Its target was to bring the rate closer to 4%. It is for reining in inflation and money supply in the system.

- **Tightening move for controlling Inflation**

Since inflation rate (7 per cent) exceeded the RBI's inflation target range of 2-6%, our central bank shifted its attention towards not only keeping inflation below the 6% upper tolerance limit, but also tightening the policy to bring inflation around 4%. Thus RBI wanted to tighten liquidity to control inflation and money supply.

Larger government borrowings and abundant supply of liquidity are the great concerns to RBI.so it planned to apply liquidity management tools like OMO proactively to control money supply and inflation expectations.

- **Liquidity control Ahead of Festive Seasons**

During the festive and wedding seasons (October-January), the demand for cash will be high. Large amount of liquidity is withdrawn from the banking system and naturally spending on consumption goods will increase. Also the government spending will fall during these periods. As a result liquidity will be tightened.

- **Avoiding cash crunch**

Advance tax payments and GST payments drained out the liquidity and OMO sales is a pre-emptive action to avoid a liquidity crunch later during peak festival season. It helps the RBI to proactively manage liquidity and avoid situations of excess or shortage of cash.

Key issues:

- **Anticipation of Liquidity Tightening**

Usually the core liquidity in the banking system decreases during the festive seasons and the need for OMOs will not arise much. But the unanticipated announcement indicated a proactive approach to liquidity management by the RBI which found the market players off their guard.

- **Restrictive approach towards inflation**.

Despite a high level of retail inflation, the market did not expect the move to withdraw excess liquidity. Monetary policy got a hawkish tint as this step is often associated with a more restrictive monetary stance.

- **Festival Season Impac**t

Market expected a more accommodative approach to meet the increased demand for cash in festive seasons. But RBI signalled a restrictive stance on liquidity management even though liquidity naturally tightens due to more withdrawals of cash from banks.

- **Importance to Liquidity Management.**

The RBI's emphasis on active liquidity management was influenced by inflation risks and financial stability. A more proactive approach to monetary policy was signalled.

- **Uncertainty and Speculation**

The unexpected announcement and the absence of OMOs timing created uncertainty in the market. The level of liquidity at which the RBI might plan OMO sales and the quantum of these operations are still remains uncertain. This uncertainty and change in stance led to market volatility and adjustments in asset prices.

Importance of Open Market Operations:

- **Maintaining Liquidity**

OMOs enable RBI to maintain and control the level of liquidity in our economy. The RBI can inject or withdraw money from the banking system through the sale or purchase of government securities (G-Secs and T-Bills). It helps to ensure an appropriate level of funds available in the market, which is vital for the smooth functioning of financial markets and the effective transmission of monetary policy.

- **Managing Interest Rates**

Sale and purchase of securities by RBI affects their prices and bring out changes in their yields which in turn affect interest rates. Lower yields result in lower borrowing costs for the government and other borrowers, while higher yields mean higher borrowing costs.

- **Influencing Exchange Rates**

When RBI purchases securities, the supply of rupee will increase in the market which in turn put downward pressure on the exchange rate, making the rupee weaker against other currencies. Conversely, when the RBI sells government securities, availability of rupee in the market will fall and putting upward pressure on the exchange rate, thereby rupee becomes stronger.

- **Flexibility**

It is a flexible tool in the hands of RBI to manage liquidity in the financial system. While other monetary policy instruments are used with fixed schedules, OMOs can be conducted as needed, depending on the prevailing liquidity conditions in the market. This flexibility allows the central bank to respond quickly to changing economic conditions and market dynamics.

- **Transparency**

RBI is used to detail the amount, date and time of OMOs through press releases. OMO operations are carried out openly and are often conducted through auctions .This practice gives clarity to the market participants and ensures transparency

- **Effectiveness and Efficiency**

Through OMOs RBI injects or withdraws liquidity in the banking system, thereby putting downward or upward pressures on interest rates in the economy. Thus OMOs act as a powerful tool for fine tuning the economy.

- **Complementarity with Other Instruments**

RBI uses OMOs with other monetary instruments like Repo rate, cash reserve ratio to achieve the policy objectives by having a desired level of liquidity and to have a comprehensive strategy to address the macro economic issues.

Challenges and Limitations:

- **Fiscal Dominance**

Through open market purchase of securities, it indirectly finances the government's fiscal deficit. It means that government's fiscal needs become dominant than monetary policy goals. When the RBI sells government securities, it can increase the government's interest burden and crowd out private-sector borrowing, thereby affects credit allocation.

- **Liquidity Management Challenge**

Too much injection of liquidity will hamper the effectiveness of RBI's policy on interest rates and fuel inflationary pressures. Absorbing too much liquidity may result in a liquidity crunch which in turn affects the transmission mechanism of monetary policy.

- **Exchange Rate Volatility**

OMOs influences the supply and demand for foreign exchange in the market. It may lead to fluctuations in exchange rate of Rupee which affects trade and capital flows. Further changes in the RBI's foreign exchange reserves will expose the RBI to valuation losses and thereby ability to intervene in the forex market will be affected.

CONCLUSION

Coordination of OMOs with other monetary policy instruments and public debt management are essential to maintain consistency in policy actions and minimizes the risk of conflicts between different policy goals. Market participants should be able to understand the central bank's intentions and actions. For this Transparency and predictability in OMO operations are to be ensured.it helps to reduce uncertainty and promotes stability and confidence among investors. RBI should be ready to positively respond to the emerging challenges and adjust the OMO strategies to meet the changing macro-economic and financial conditions. OMOs effectiveness in stabilizing economies and achieving monetary policy objectives depends on the central bank's ability to accurately time and size these operations.

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